United States Court of Appeals

for the Second Circuit

AMICUS BRIEF

75-7203

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

B
PLS

ROBERT ABRAHAMSON and
MARJORIE ABRAHAMSON,

Plaintiffs-Appellants,

vs.

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, LEON POMERANCE, FLESCHNER BECKER ASSOCIATES, and HARRY GOODKIN & COMPANY,

Defendants-Appellees.

On Appeal from the United States District Court for the Southern District of New York.

BRIEF OF A.W. JONES & ASSOCIATES; A.W. JONES COMPANY; AVALON; EUCLID PARTNERS; GOODNOW, GRAY & CO. AND JUBILEE AS AMICI CURIAE

SEWARD & KISSEL
Attorneys for Amici Curiae
63 Wall Street
New York, New York 10005
(212) 248-2800

W. JOHN NAUSS, JR.
BLAISE G.A. PASZTORY
ANTHONY R. MANSFIELD
Of Counsel

11

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

NO. 212 - SEPTEMBER TERM, 1975

DOCKET NO. 75-7203

- -x

ROBERT ABRAHAMSON and MARJORIE ABRAHAMSON,

Plaintiffs-Appellants,

-against-

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, LEON POMERANCE, FLESCHNER BECKER ASSOCIATES and HARRY GOODKIN & COMPANY,

Defendants-Appellees.

- -x

ANSWERING BRIEF OF AMICI CURIAE A.W. JONES & ASSOCIATES; A.W. JONES COMPANY; AVALON, EUCLID PARTNERS; GOODNOW, GRAY & CO. AND JUBILEE

Pursuant to the Order of this Court dated April 15, 1977, the A.W. Jones Amici* submit this answering brief to urge the Court to modify its February 25, 1977 decision herein (1) to hold that the general partners of an investment limited

*A.W. Jones & Associates; A.W. Jones Company; Avalon; Euclid Partners; Goodnow, Gray & Co. and Jubilee are referred to herein as the "A.W. Jones Amici."

partnership are not investment advisers within the meaning of the Investment Advisers Act of 1940 ("Advisers Act"), or (2) if the general partners are investment advisers, to hold that their only client is the partnership.

At a minimum, the A.W. Jones Amici join in the request of the Securities and Exchange Commission ("SEC") that the Court refrain from ruling that the clients of the general partners are the limited partners.

1. The SEC does not Oppose the Position that if the General Partners were Investment Advisers, their only Client was the Partnership.

Nowhere does the SEC (nor do plaintiffs) directly oppose the position and analysis set forth in the original briefs of amici that if the general partners of investment limited partnerships are investment advisers within the meaning of the Advisers Act, their only client is the partnership itself and not the limited partners. The SEC seeks to deflect the issue by admitting that it "has not yet taken a position" on this question. (SEC Supp. Brief at 20, n. 34) It should not be permitted to so deflect the issue. The analysis of the original briefs of amici stands. Accordingly, the Court should hold that if the general partners are investment advisers, they have but one client -- the partnership.

Recently, the SEC stated that where a valid legal entity having a management separate from its members has been formed, it will be considered to be one investment advisory client. In response to an inquiry made by a member of an investment club who was to make investment decisions and perform other services for it "for a small fee", the SEC (in an interpretive letter released only a month ago) stated:

> [T]he question of whether you are required to register [as an investment adviser] will depend on whether the investment club is considered as your client or whether the members of the club are considered your clients. The answer to this que ion will depend on whether the club should be regarded as a separate entity. This will depend, to a large extent, on whether the business of the club is managed by a board of directors or by the vote of a majority of the club members. The former would be a factor in favor of considering the club as the client. The latter would be a factor in favor or considering the members your clients. Frank A. Dunn (Avail. March 11, 1977). [A copy of the correspondence is attached as Appendix hereto.]

The SEC's reasoning in Frank A. Dunn supports the conclusion: an investment limited partnership is one investment advisory client under the Advisers Act. Investment limited partnerships are legal entities properly established for a valid business purpose. This is set forth in the original brief of the A.W. Jones Amici. The business of the investment limited partnership is managed by the general partners. Indeed, it must be so. A limited partner cannot escape liability if he participates in the management of the partnership. N.Y. PARTNERSHIP LAW §96 (McKinney's 1977). The test propounded by the SEC -- that the

entity be managed by a management separate from the individual participants -- is met even more clearly than in Frank A. Dunn. It is the partnership, rather than the limited partners, which is the client.

2. The Statement that the Investment Advisory Clients of the General Partners are the Limited Partners was Unnecessary to the Court's Decision. The SEC and Plaintiffs-Appellants Agree.

A.W. Jones Amici and amicus curiae Steinhardt, Berkowitz & Co. in their original briefs contended: the statement of the Court that the general partners of Fleschner Becker Associates were advisers to the limited partners (Slip Op., n. 16 at 6227) was unnecessary to the decision. The SEC agrees and expressly asks the Court to delete the statement from the opinion:

> Amici A.W. Jones and Steinhardt argue that the Court's statement that "[t]he general partners as individuals, not FBA as an entity, were the investment advisers to the limited partners." [Current] CCH Fed. Sec. L. Rep. at p.91,282 n.16 (emphasis added), went beyond that necessary for the court's decision. A.W. Jones Br. at 6; Steinhardt Br. at 11.
>
> The Commission does not disagree that the portion of this statement underlined above is not necessary to the Court's holding. In any event, we believe that the statement is, taken in context, meant to identify the advisers, not the clients. Since it is not necessary for the court to decide whether the general partners had one client (the partnership) or 66 (the limited partners), and since the Commission has not yet taken a position with respect to this

> question, we respectfully suggest that the Court might consider amending its decision by deleting the underlined portion of the sentence in question. (S.E.C. Supp. Brief at 20 n. 34) [Emphasis added in second paragraph.]

Plaintiffs tacitly agree the question of whether the defendant general partners were advising the partnership or its partners need not be decided by the Court in this action. (Plaintiff's Supp. Brief at 36, fn.).

A.W. Jones Amici respectfully request the Court to state in its opinion that the question of whether the general partners were advising the partnership or its limited partners was not decided or required to be decided. This modification is necessary to make clear that this decision, where the question was not reached, may not be used in the future as a basis for denying exemption from registration pursuant to Section 203(b)(3) of the Advisers Act to investment limited partnerships otherwise entitled to such exemption.

A.W. Jones Amici endorse the SEC's recommendation and respectfully urge the Court to amend its decision at least by deleting the words "to the limited partners" in footnote 16.

3. Since they Invest Substantially in the Partnerships they Manage, the General Partners are Not Investment Advisers Within the Intent of Section 202(a)(11) of the Advisers Act.

The legislative history of the Advisers Act supports the view that where the general partners have a substantial stake in the partnership they are not intended to be within

the scope of the Advisers Act. That history directly contradicts the SEC's assertions that it is "irrelevant . . . that the general partners themselves invested . . . their own money through the partnership" and that it is "irrelevant . . . that, because [the general partners] assumed the 'full risk' of the partnership's liabilities, their business stands 'in sharp contrast to the kind of riskless activity by investment advisers which Congress sought to regulate under the (Investment Advisers) Act'. . . ." (SEC Supp. Brief at 7-8). The Senate reports reveal that a principal motive of Congress in enacting the Advisers Act was to regulate investment advisers who manage the accounts of others without risk to themselves.

The SEC conducted a four year survey of the investment industry and reported its conclusions and recommendations to Congress in Investment Trusts and Investment Companies: Hearings on S.3580 Before the Subcomm. of the Comm. on Banking and Currency. 76th Cong. 3d Sess. (1940) (hereinafter "the Senate Hearings"). These hearings resulted in the enactment of both the Advisers Act and the Investment Company Act of 1940. In speaking to the adoption of both acts Robert E. Healy, the SEC's supervisor of the study, pointed out in his opening statement to the Senate that one of the principal abuses to be eradicated by the proposed legislation was the investment adviser's ability to give advice while personally in a risk free position:

APPENDIX

> Insiders have also engaged in practices which permitted them to obtain large profits without any risk, by trading in the securities issued by the trust, to the pecuniary detriment of their investors. . . . [T]hese promoters and insiders . . . accomplish these personal gains and . . . insure their control of the public funds without the necessity of substantial investment of their own funds. . . . Senate Hearings at 37-38.

Likewise, Baldwin B. Bane, Director of the SEC's Registration Division, advised the Senate: "These trusts always use other people's money. Very few sponsors, underwriters, or managers have substantial investments in these trusts." Senate Hearings at 143.

Unlike the investment advisers who were the primary target of the Advisers Act, the general partners of investment limited partnerships stand to lose their own substantial investments. They do not profit without risk, and thus they do not benefit from acting in a manner contrary to the interests of the limited partners. The legislative history leads to the inescapable conclusion that those who have a substantial participation in investment risks were not intended to be regulated as investment advisers.

New York, New York
May 13, 1977

Respectfully submitted,

SEWARD & KISSEL
Attorneys for Amici Curiae

W. John Nauss, Jr.
Blaise G.A. Pasztory
Anthony R. Mansfield
Of Counsel

Washington Service Bureau, Inc.

Subject: Dunn, Frank A.

WSB File # 3-2-1-77-72

Location in Index

Section 202(a)(11), 203(b)

Rule

Public Availability 3/11/77

November 6, 1976

Sir:

Several of my friends and I recently formed an investment club. The total membership is twenty. Our board of directors has named me to make all investment decisions and handle all bookkeeping and accounting chores. I am paid a small fee for providing these services. The brokerage firm has questioned whether I should be registered as an investment adviser. The subtle point in question seems to be whether I am making decisions for twenty individuals (the members) or one individual (the club). I would like to know whether registration is required.

If registration would be required when I act in the role described above, we would like to amend our charter so that investment decisions would be made by vote of the board of directors. The board consists of five members. If this amendment were made, would we be exempt from registration or would all five board members be required to register as investment advisers?

If, under the proposed amendment, all five members would be required to register, please indicate some method of organization which would exempt all of us from registration.

Sincerely,

Frank A. Dunn

Frank A. Dunn
394 Beverly Blvd.
Upper Darby, Pa. 19082

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Frank A. Dunn
Our Ref. No. 76-660CC
File No. 132-3

FEB 9 1977

PUBLIC

Section 202(a)(11) of the Investment Advisers Act of 1940 (the "Act") defines an "investment adviser" as "... any person who, for compensation, engages in the business of advising others, either direct or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.. ."

Your letter states that you make all investment decisions for the club for which you are paid a small fee. Therefore, you would come within the above definition of an investment adviser under the Act, and you would be required to register under the Act unless you could rely on one of the exemptions from registration in Section 203(b).

Section 203(b)(3) of the Act provides that registration is not required for any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act of 1940. You may be deemed to be holding yourself out to the public as an investment adviser if, for example, you maintain a listing as an investment adviser in a telephone directory or a business directory or otherwise express a willingness to existing clients or others to accept new clients, or if you use a letterhead indicating any activity as an investment adviser.

If you do not hold yourself out generally to the public as an investment adviser, and if the club is not required to register under the Investment Company Act of 1940, the question of whether you are required to register will depend on whether the investment club is considered as your client or whether the members of the club are considered your clients. The answer to this question will depend on whether the club should be regarded as a separate entity. This will depend, to a large extent, on whether the business of the club is managed by a board of directors or by the vote of a majority of the club members. The former would be a factor in favor of considering the club as the client. The latter would be a factor in favor of considering the members your clients.

If the charter were amended so that investment decisions would be made by a vote of the board of directors, as such, it would not, in ordinary circumstances, be required to register as an investment adviser. As members of the investment club and as a representative body of the club, the board of directors would probably not be engaging "in the business of advising others" as provided in the definition of an "investment adviser" in Section 202(a)(11) of the Act. The board would be providing its own investment advice. In essence, the board would not be a separate entity, but would be a part of the investment club making investment decisions for the club. The situation might be different if the board of directors organized several clubs for which they provided investment advice in the guise of functioning as directors. In such a situation, the board of directors would probably be considered investment advisers, engaging "in the business of advising others," and would be required to register under the Act.

The general anti-fraud provisions of Section 206 of the Act apply to all investment advisers, whether or not they are registered or required to be registered.

You should also be aware that an investment club in which investment decisions are not made by vote of the members may be subject to the Investment Company Act of 1940 if it has 100 or more members or if it makes a public offering of memberships.

In this connection, I am enclosing for your information a memorandum on "The Organization of Investment Companies and the Investment Company Act of 1940."

Stanley B. Judd, Assistant Chief Counsel
Division of Investment Management

Enclosures

Sneed/SBJ/dp

CERTIFICATE OF SERVICE

Services of two copies of the annexed Brief of A.W. Jones & Associates; A.W. Jones Company; Avalon; Euclid Partners; Goodnow, Gray & Co. and Jubilee as Amici Curiae was made upon the following counsel for the parties herein by placing same in the United States mail, postage prepaid this 13th day of May 1977:

Richard E. Carlton, Esq.
Messrs. Sullivan & Cromwell
48 Wall Street
New York, New York 10005
Attorney for Defendants-Appellees
Malcolm K. Fleschner, William J.
Becker and Fleschner Becker Associates

Richard McGahren, Esq.
Messrs. D'Amato Costello & Shea
116 John Street
New York, New York 10038
Attorney for Defendant-Appellee
Harry Goodkin & Company

Mark Jaffee, Esq.
Messrs. Hill, Betts & Nash
One World Trade Center
Suite 5215
New York, New York 10048
Attorney for Defendant-Appellee
Harold E. Ehrlich

Ronald Alenstein, Esq.
Messrs. Shea, Gould, Climenko & Casey
330 Madison Avenue
New York, New York 10017
Attorney for Plaintiffs-Appellants

Harvey L. Pitt, Esq.
General Counsel
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549
Attorney for the Securities and
Exchange Commission, Amicus Curiae

Paul N. Roth, Esq.
Messrs. Baer & McGoldrick
460 Park Avenue
New York, New York 10022
Attorney for Steinhardt, Berkowitz o.,
Amicus Curiae

Barbara E. Sheehan

63 Wall Street
New York, New York 10005
(212) 248-2800